

- An Immediate Corrective Action Is Needed.

This Is An Open Letter To All Concerned With This Matter

BSS MICROFINANCE Pvt. Ltd..

(Formerly Oyster Capitals Pvt. Ltd.)

Reg. Off: No. Com-9, Devaraja Urs Truck Terminal,

Peenya Main Road, Opp. Kanteerava Film Studio,

Yeshwanthapura, Bangalore - 560022,

Tel: +91-80-6573-2387, 3271-1266, 4175-0976, Fax: +91-80-2347-1884

E-mail: swamukti@swamukti.com, bss@bssmicrofinance.co.in.

www.bssmicrofinance.co.in.

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**Sub: Malegam Committee Recommendations Have One Fatal Flaw
& Raise Many Difficult Questions**

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From: Dr. Ramesh Bellamkonda

Managing Director

BSS Microfinance Private Limited, Bangalore.

(The Opinions Expressed Here Are Solely Those Of The Author)

One Fatal Flaw In Malegam Committee Recommendations:

1. Summary Recommendation 10, (11.12 (c)), that says “**Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all recoveries should only be made at the Group level at a central place to be designated**” is **a recommendation that is absolutely fatal to microfinance. If adopted, this will be a “Death Sentence”, nothing short.** If this recommendation is adopted by the regulator, all that a borrower has to do to not repay, is to stop coming to the central designated place of collection of repayment. If the MFI staff go to borrowers’ homes or work places in such a circumstance, the MFI staff would have violated the applicable regulations and the borrowers or others around them can call the police and have such MFI staff arrested. In a relatively short time, people will figure out how to not repay MFI loans. Some borrowers or their families or their neighbours or third parties will surely want to exercise this option. Once exercised by some people here and there, this would have an extremely contagious effect on just about every one else and every where else. **Soon, all collections will collapse. What is in Andhra State now, will be all over India.**

Loan repayment takes conscious effort and discipline on the part of the borrower. It often feels a little painful to most people. It does not happen automatically. If the above recommendation is adopted, the loans are guaranteed to go bad, in a relatively short time. **If I were a banker, I would not have the courage to lend to any MFI which would be bound by such a regulation! The bank’s loan will be guaranteed to become NPA if this regulation is in place!**

A Major Theme That Flows Through Malegam Committee Recommendations:

Background To the Theme: There has been a major hue and cry in the recent months and years about all the “horrible things” that MFIs have supposedly done. The fact that some large MFIs have struck it super rich for their promoters and their private investors, has earned a lot of ill will for the microfinance sector amongst bureaucrats and politicians and other influential people in the country. As an aftermath of this, the Andhra Pradesh state problem in microfinance has been precipitated. It is in this background that the Malegam Committee had to come out with its recommendations.

The Theme: The theme that flows through the recommendations is an apparent feeling of taking for granted, the near 100% repayment rates that MFIs have managed for several years. There is also a feeling of taking for granted, ready availability of microfinance facilities to the poor people. The recommendations as a result, appear to be severely restrictive to the functioning of MFIs. To say that MFIs are being put in a straight jacket, would not be an exaggeration. In addition to the one fatal recommendation above, the recommendations raise a lot of very difficult operational questions, which are listed below. While the intentions of this committee are

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undoubtedly good, they seem to have completely dropped the ball in terms of understanding or providing for intricacies, complications, and challenges, of all the day to day operations.

A Sincere Appeal: Let us not forget the abysmal repayment rates of IRDP of past years, low repayment rates of most government credit programs even today, all over the country. Even in Andhra Pradesh, a recent news report said, that the Government run micro credit program had repayment rates of 70% as of October 2010 and are falling. My sincere appeal is that near 100% repayment rates should not be taken for granted. Neither should credit availability for poor people, be taken for granted, regardless of any and all the government credit programs put together. Let our memories not be very short and let them not be selective either. Non-Government provision of credit is very important in the long run. It would be good to remove the fatal flaw in the recommendations and to substantially loosen the straight jacket that is evident throughout the recommendations. This would be in the interest of the poor people of India who genuinely need credit in the long term.

Some Difficult Questions That The Malegam Committee Recommendations Raise:

1. With regard to recommendation 7, (9.7 (b)), does it mean a borrower can be a member of one SHG and one JLG or does it mean a borrower can be a member of either one SHG only or one JLG only? I am guessing it is the second way and not the first way.

With regard to the same recommendation, What if a borrower misleads an MFI? What would be the practical real time mechanism by which it can be determined which SHG / JLG that a particular person, is a member of? This could be a very daunting operational task. Will there be a central registry or a reference data base to show which person is a member of which SHG or JLG? In the absence of such an infrastructure, there will be problems and MFIs can be unfairly blamed.

2. In Summary of Recommendations, serial number 11, 12, and 13 are missing, where as serial number 6 & 7 are repeated. There might be a problem in the PDF format that has been made available for downloading at the RBI website.
3. With regard to recommendation 7 (9.7 (a)), does a poor person (whether an active borrower or not) have the freedom to leave one JLG and join another JLG, or leave one JLG and join a SHG instead? Similarly, if a person (whether an active borrower or not) is a member of a SHG, does such a person have the freedom to leave one SHG and join another SHG, or leave one SHG and join a JLG instead? If the borrower does have an option to leave an existing SHG or JLG, what happens to the loans outstanding in the hands of other SHG or JLG members, which would have been guaranteed by this borrower? If a borrower is not allowed to leave a SHG or JLG, would that not be a violation of her basic human right to make her own choices from time to time?
4. With regard to recommendation 6 (8.7 (g)), Should it be a standard form of loan agreement across all MFIs or standard form for each MFI? If it is to be a standard form across all MFIs, who will create this standard form of loan agreement? Further, what if the MFI is working in different areas, and one or more areas have special circumstances which necessitate a change in the loan agreement for the respective areas? How about any changes that may be necessitated from time to time even within the same MFI?
5. With regard to recommendation 6, (8.7 (e)), I am assuming that insurance coverage will be provided by an insurance company, and therefore computing the insurance premium will be done by the insurance company, is that right? Or, if it is envisaged to be something different, what exactly is envisaged? Further, who should make these regulations? RBI or NABARD or IRDA or somebody else?

Further, insurance companies want premium payments to be made in advance. Is it that the insurance company will make these calculations and communicate to the MFI, the MFI will then communicate this to the borrower and collect premiums in instalments and then deliver such instalments to the insurance company, and till then the borrower will not have insurance coverage? Further, if a borrower fails to make a timely payment of an insurance instalment, would her insurance coverage lapse? Also, insurance companies typically want to issue policies with coverage for one year only, not more & not less. At the end of the policy period, it reserves every right to not continue coverage. Unless there is a good mechanism to prevent lapse in coverage during this transition, there can be substantial gaps in

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coverage when one insurance company is withdrawing from providing coverage and another insurance company is considering to provide coverage. How exactly is this whole thing supposed to operate?

6. With regard to recommendation 6, (8.7 (d)), How is effective interest rate defined and how is it expressed and how is it calculated? They should all be standardized by the regulator and there should be one national standard, in order to make such rates comparable. I have observed quite often in the past that the stated rates are expressed differently and they are calculated differently as well, due to the fact that there is not one national standard published by the regulator. Further, should the effect of ALR (Advance Loan Repayment) be included in this?

Further, there are two caps for the allowable maximum effective rate, namely 24% or average yearly financial cost plus 10%, which ever is lower. Each lender to MFIs has different rates and terms and conditions, and even the same lender has different terms and conditions and rates for different loans to the same MFI. The average yearly financial cost of all borrowings from different banks for each MFI, will therefore be known only after the year is over. Given this reality, how is the MFI to know what interest rate to charge at the time of making a loan to an individual borrower? Further how is the MFI to print such a chargeable interest rate before even the MFI can itself figure out what the allowable charge is? Further, if a loan from an MFI to a borrower extends across two or three different financial years, and the cap for each financial year on what the MFI can charge is different (based on what the MFI's average yearly financial cost is for each year in question), how is the MFI to charge the end client for that loan? Will it be different during each financial year for the same continuing loan (from the MFI to the end client)? How is this supposed to work?

7. With regard to recommendation 6, (8.7 (b)), Is insurance administrative cost not part of actual insurance cost? Or, is it that the administrative cost is to be fully in the form of subsidy by the MFI to the end borrower?
8. With regard to recommendation 6, (8.7 (a)), presently one or more large MFI/s routinely allow ALR (Advance Loan Repayment) which effectively acts as a temporary interest free deposit from the borrower with the MFI, which the borrower can apply towards loan repayment instalments at a future time. This also effectively decreases the net loan amount advanced by the MFI to the end client, net of ALR, even though interest is collected on the full gross loan amount outstanding, before adjusting it for ALR. Such ALR amount typically has been very substantial in relation to the loan portfolio outstanding of the MFI/s in question. In such a scenario, should the net amount of interest chargeable by the MFI on the borrower be correspondingly decreased? Or is that not necessary? Presently, the recommendations are silent on this aspect, but this aspect does need to be addressed by the regulator.
9. With regard to recommendation 10, (11.12 (a)), What is the definition of "coercive methods"? This must be clearly defined, keeping in mind, all practical aspects. Without such a definition, the MFIs can be falsely accused of using coercive methods and on the contrary, the MFI may be fearful of using even perfectly reasonable methods to avoid getting into difficulty, and all this can damage the MFI.
10. With regard to recommendation 10, (11.12 (c)), What happens if a group does not come to a central designated place and/or does not make payments due as scheduled? What is the MFI supposed to do?
11. With regard to recommendation 9, (10.5 (b)), If the MFI is misled by the borrower and thus grant a loan which should not have been granted had the MFI known the truth, then would the MFI have to suffer for granting a loan in what would be a violation of the new regulations?
12. With regard to recommendation 7, (9.7 (e)), If an MFI mistakenly makes a loan to a borrower who is beyond the limit of total indebtedness, while such an MFI will be prevented from recovering its loans until the earlier loan/s of the borrower are repaid in full to the earlier lender/s, Is it ok to recover interest only in the meantime? Or, is interest recovery also barred? Further, is this MFI required to show such loans as overdue in its books and make suitable provisions, or is it allowed to reschedule the loan and show it as not being due till the earlier loans of the borrower are repaid to those earlier lenders?
13. With regard to recommendation 5, (7.11), What happens to an MFI whose administrative costs and loan loss provisions and loan losses together exceed 10% of the average loan portfolio in any financial year? Such an MFI would have to incur losses and therefore banks can stop further lending and may

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possibly recall loans already made. Overall, any MFI whose all costs other than financial costs exceed 10% of the average loan portfolio outstanding (net of any loan loss provisions) in any financial year, would be in danger of collapse. Is that what is intended to happen?

14. With regard to recommendation 3, (5.9 (b) (i)) (income limit of Rs.50,000/- for a microfinance borrower household), How is household defined? Does it include members of a joint family or a semi-joint family (as when one or more close relative/s live in the same house and happen to be earning members)? Further, should this figure be indexed to inflation?

Further, how will we ensure the accuracy of this income figure? Most of the figures we can realistically obtain are very approximate at best. What happens if a loan is made to a household and then somebody disputes that its income annually is in fact more than Rs.50,000? For a salaried person, the salary can be exactly known, but not for most poor households where unless the household keeps accurate accounts, there will be no way to know, and most poor persons will find it nearly impossible to keep accurate accounts of their net income.

15. With regard to recommendation 3, (5.9 (b)(vi)), Would the MFI have any say in whether the repayment will be weekly, fortnightly or monthly, or is it entirely left to the borrower's choice? If it is entirely a matter of borrower's choice, can the borrower change her mind on the frequency of repayments from time to time?

16. With regard to recommendation 12.6, When a bank lends to an MFI, the MFI would be the bank's client. Is the bank required to observe the same code of conduct in dealing with the MFI as the MFI is required to do with the end client? Does the MFI get any benefit of the client protection code when banks interact with the MFI?

17. With regard to item 12.3(b) (about avoidance of over-indebtedness), While this is acceptable as a principle of intent, how is this to be operationalized? It is essentially subjective and very open to being disputed, particularly if and when the borrower defaults or complains at a later date, of being over indebted or of being unable to make instalment payments. I am concerned about MFIs being unfairly blamed.

18. With regard to item 12.3(i), What does this mean to protect privacy? Does it mean when a third party asks for loan details of a borrower, the same will not be given? Does it mean that enquiries about the living and working of a person cannot be made from neighbours and those around the borrower? Does it mean information cannot be given to a credit bureau or to another MFI or to another lender? Does it mean we do not share information about a difficult borrower with another MFI? Does it mean we cannot talk about a borrower with other JLG members of that borrower? There should be clarity about this requirement so that MFIs will not be unfairly blamed.

19. With regard to item 10.5(b) (about existing borrowings of the potential borrowers), What happens if the information given by the borrowers is misleading and/or the information reported by MFI staff is faulty or erroneous? Will the MFI be penalized for that?

20. With regard to item 5.9(b)(ii), After taking Rs.25,000/- loan from one or two MFIs, what if the borrower borrows from other (non-MFI) lenders and traders who give credit etc? What can the NBFC-MFI do? People routinely get into debts far in excess of this amount for reasons of ill health in the family, marriage, etc. Also, would this not actually severely stunt the small business of a poor entrepreneur from growing? A single milch cow could cost Rs.25,000/- or more. What happens if a borrower with a loan of Rs.25,000/- sustains a loss of Rs.25,000/- either in his/her business or due to death of a milch cow or ill health in the family etc? Say, his indebtedness meets or exceeds the Rs.25,000/- limit, which he is unable to repay due to this loss. Will such a person be condemned to a life without credit for the rest of his life?

Also, what happens if there are two different borrowers from the same household? Will the Rs.25,000/- limit be per borrower or per household? This should be addressed.

Also, should this figure of Rs.25,000/- indexed to inflation?

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21. With regard to item 5.1, Does this mean that a NBFC can either have >90% of its loan portfolio in microfinance or it cannot have more than 10%? Why should it not be allowed to have 20% or 50% or any other percentage between 10% and 90%? Whether it will be called a NBFC- MFI or not is a separate issue, but this sounds like it is not even allowed to have anything between 10% and 90% of its portfolio in microfinance loans. what would be the benefit of such a restriction?

Does it also mean that all NBFCs will be asked to declare that they do not have >10% of its assets in microfinance loans? Will this be one of the items they will be audited on? What happens if the NBFC has not measured the household incomes and therefore does not know if a loan it has made has to be called a microfinance loan or not?

Some Other Question/s That The Recommendations Raise:

1. With regard to item 17.5, by definition, is it not true that net owned funds is the same as Tier I Capital? Is there ever a possibility of Tier I capital not being net owned funds or a possibility of net owned funds not being Tier I capital? If Tier I capital and net owned funds are one and the same, then what is the significance of the second portion of recommendation no. 17 (17.5)?
2. If an MFI or a NBFC does not wish to take advantage of priority sector lending status for small value loans to poor people, would all of the above regulations still apply? (I am assuming 'Yes', but it will be good for the regulator to clarify).

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From:

Dr. Ramesh Bellamkonda, Managing Director

BSS Microfinance Private Limited, Bangalore.

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